

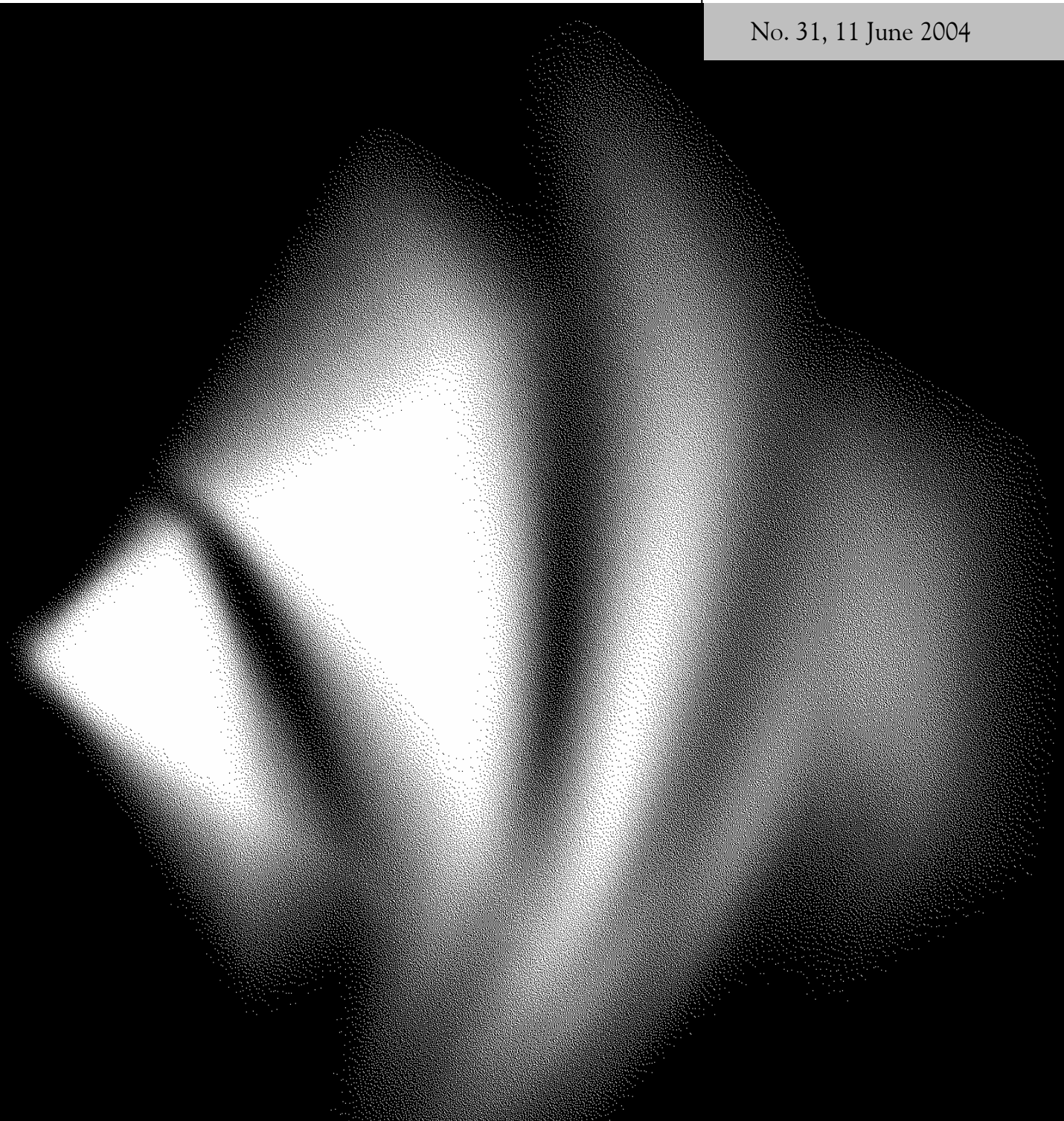


Australian Government
Productivity Commission

Review of the Gas Access Regime

Productivity
Commission
Inquiry Report

No. 31, 11 June 2004



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Terms of reference

I, PETER COSTELLO, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer the following to the Commission for inquiry and report within twelve months of receipt of this reference.

Background

The National Third Party Access Regime for Natural Gas Pipelines (Gas Access Regime) was established in November 1997 by agreement of the Commonwealth, State and Territory Governments. The Gas Pipelines Access Law, including the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code) implements the access objectives agreed by all jurisdictions.

II. The efficient implementation and operation of the Gas Access Regime has the potential to contribute significantly to the energy policy objectives identified by the Council of Australian Governments (CoAG). The Commonwealth Government has released its interim response to the Review of Part IIIA of the *Trade Practices Act 1974* (the National Access Regime) under which the Gas Code is certified. In addition, the imminent completion of regulators' final decisions in the first round of access arrangements means that there is now an emerging case history that allows an assessment of the effectiveness of the Gas Access Regime.

III. The primary aim of this Review is to follow the National Access Regime Review and to examine the extent to which current gas access arrangements balance the interests of relevant parties, provide a framework that enables efficient investment in new pipeline and network infrastructure and can assist in facilitating a competitive market for natural gas. There is no intention that the Review reconsider existing or pending access arrangements.

Scope of inquiry

IV. Within the framework of Part IIIA of the *Trade Practices Act 1974*, clause 6 of the Competition Principles Agreement 1995, the National Energy Policy Framework agreed by CoAG in June 2001 and outcomes arising from the CoAG Independent Review of Energy Market Directions, conduct a review of the Gas Access Regime to:

1. Analyse and, as far as reasonably practical, assess the benefits, costs and effects of the Gas Access Regime, including its effect on investment both in the sector and in upstream and downstream markets.

-
2. Identify any necessary improvements to the Gas Access Regime, its objectives and its application, and in particular the Gas Code, to ensure uniform third party access arrangements are implemented and applied on a consistent, national basis. The Report of the review should consider and where appropriate make recommendations on:
 - a) how the Gas Access Regime might better facilitate a competitive market for energy services, including through the promotion of:
 - i) commercially negotiated outcomes;
 - ii) effective upstream and downstream competition;
 - iii) effective retail contestability on a consistent and timely basis; and
 - iv) a competitive market for natural gas.
 - b) the appropriate consistency between the Gas Code, the National Access Regime and other access regimes, including in relation to regulatory roles, responsibilities and accountability, and whether transmission and distribution assets require separate approaches.
 - c) the Gas Code's effect on investment in transmission pipelines and distribution networks, including the operation of those parts of the Code dealing with the tender process, ring fencing, information gathering and expansions/extensions of pipelines and networks.
 - d) the institutional and decision-making arrangements under the Gas Access Regime.
 3. Identify and investigate the appropriateness of including in the Gas Code minimum (price and non-price) requirements by which pipeline and/or network owners and operators can provide a fully competitive, open and transparent third party access service on a non-discriminatory and economically efficient basis to users.

Considerations

V. In making assessments, and in recommending changes to the Gas Access Regime including the National Third Party Access Code for Natural Gas Pipelines, the Review should take into account:

1. Pricing and non-pricing aspects of monopoly and competitive market behaviour;
2. Different roles and requirements of transmission and distribution networks;
3. The need to maintain an appropriate balance between investor, asset operator, gas producer and current and future gas consumer interests;

-
4. Certainty, transparency, timeliness and accountability requirements for regulated network services, compliance costs, and appropriate incentives for longer term efficiency and productivity improvements;
 5. Economic and regional development, environmental, energy security, fuel choice, financial risk management and business competitiveness considerations; and
 6. Consistency with Part IIIA of the *Trade Practices Act 1974*, in particular with relation to the objects clause and pricing principles.

VI. In considering these terms of reference, the Report should also take account of:

1. The Governments' response to the Productivity Commission's Review of the National Access Regime;
2. the Governments' response to the CoAG Independent Review of Energy Market Directions; and
3. relevant court cases including the Australian Competition Tribunal decision and findings on the Eastern Gas Pipeline, May 2001 and the Supreme Court of Western Australia judgement on the Dampier to Bunbury natural gas pipeline, August 2002.

VII. The review is to consult with key interest groups and affected parties, issue a draft report, hold hearings and produce a final report within twelve months.

PETER COSTELLO

[Reference received 13 June 2003]

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Abbreviations and explanations

Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ACCC	Australian Competition and Consumer Commission
ACG	Allen Consulting Group
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
AGA	Australian Gas Association
AGL	Australian Gas Light Company
AMDQ	authorised maximum daily quantity
APIA	Australian Pipeline Industry Association
APT	Australian Pipeline Trust
ARC	Administrative Review Council
ASIC	Australian Securities and Investments Commission
CAPM	capital asset pricing model
CCIWA	Chamber of Commerce and Industry of WA
COAG	Council of Australian Governments
CPA	Competition Principles Agreement
DAC	depreciated actual cost
DEA	data envelopment analysis
DORC	depreciated optimal replacement cost
EAPL	East Australian Pipeline Limited
ENA	Energy Networks Association
ERA	Economic Regulation Authority
ESC	Essential Services Commission (Victoria)

Gas Access Regime	National Third Party Access Regime for Natural Gas Pipelines
Gas Code	National Third Party Access Code for Natural Gas Pipeline Systems
GPAL	Gas Pipelines Access Law
IEA	International Energy Agency
IPART	Independent Pricing and Regulatory Tribunal
IRR	internal rate of return
LNG	liquefied natural gas
LPG	liquefied petroleum gas
MCE	Ministerial Council on Energy
NCC	National Competition Council
NECG	Network Economics Consulting Group
NERA	National Economic Research Associates
NGPAC	National Gas Pipelines Advisory Committee
NPV	net present value
OECD	Organisation for Economic Cooperation and Development
OffGAR	Western Australian Office of Gas Access Regulation
PEG	Pacific Economics Group
PSO	Price service offering
QCA	Queensland Competition Authority
ROR	rate of return
SEA Gas	South East Australia Gas
SRMC	Short-run marginal cost
TFP	total factor productivity
TPA	Trade Practices Act 1974
WACC	weighted average cost of capital

Explanations

Billion	The convention used for a billion is a thousand million (10^9).
Findings	<i>Findings in the body of the report are paragraphs highlighted using italics, as this is.</i>
GJ	Gigajoule (10^9 joules).
PJ	Petajoule (10^{15} joules).
Recommendations	<i>Recommendations in the body of the report are highlighted using bold italics, as this is.</i>
TJ	Terajoule (10^{12} joules).

Glossary

Access arrangement	Arrangement by owner or operator of a covered pipeline setting out the terms and conditions and tariffs on which third parties may seek access to the services of the pipeline. Access arrangements must be approved by the relevant regulator as complying with the requirements of the Gas Code.
Binding coverage ruling	A binding ruling is a ruling on coverage given prior to the commitment to invest in a new pipeline. The ruling is made using the coverage criteria and processes. A binding coverage ruling could apply for (a) a fixed period after the new pipeline commences operations; (b) until specific criteria, such as a certain cumulative level of profit, are met; or (c) until circumstances are judged to have changed in such a way as to warrant revocation of the ruling. A binding coverage ruling has the same effect as a regulation free period (see definition below) if a ruling is made in favour of no third party access regulation for a certain period without conditions after the regulation free period has been granted.
Coverage process	Process by which a pipeline becomes covered under the Gas Access Regime.
Covered pipeline	Pipeline to which the provisions of the Gas Code apply.
Distribution	The transport of gas through smaller diameter, lower pressure pipelines to end users and consumers.
Downstream	That part of the gas industry which includes distribution and marketing.
Foundation contracts	Longer term contracts between service providers and prospective users prior to pipeline construction. These contracts effectively underwrite pipeline investment and reduce some of the pipeline investor's risk.

Greenfields pipeline	Proposed pipelines and new pipelines, the market for the output of which was previously non-existent.
Judicial review	Proceedings seeking civil penalties, damages, injunctions or declarations in relation to alleged breaches of the Gas Code.
Merit appeal	A tribunal review of a decision on the merits (undertaken by a review tribunal). The tribunal can ‘step in the shoes’ of government decision makers and affirm, set aside or vary the decision according to the merits of individual cases.
Reference service	A service that is specified in an access arrangement and in respect of which a reference tariff has been specified in that access arrangement.
Reference tariff	A tariff specified in an access arrangement as corresponding to a reference service and which has the operation that is described in ss6.13 and 6.18 of the Gas Code.
Regulation free period	A period during which a new pipeline cannot be subjected to third party access regulation. A regulation free period commences when a new pipeline starts operating and may last for either a fixed period or continue until specific criteria, such as a certain level of cumulative profit, are met. Regulation free periods can be either automatic for all new pipelines, or be restricted to new pipelines that meet certain criteria, such as vertical separation of ownership.
Ring fencing	The separation of the business of providing transmission and distribution services from other related businesses.
Schedule A	Schedule A of the Gas Code, listing pipelines that were covered from the commencement of the Gas Code.
Service provider	In relation to a pipeline or proposed pipeline, the person who is, or is to be, the owner or operator of the whole or any part of the pipeline or proposed pipeline.
Transmission	The transport of gas through larger diameter, higher pressure pipelines from a production area into a distribution network or directly to a large consumer.

Truncation	Truncation occurs where the distribution of return is constrained due to regulation.
Upstream	That part of the gas industry covering gas exploration, production and processing, and the transportation of raw gas through gathering lines.

OVERVIEW

Key points

- The National Third Party Access Regime for Natural Gas Pipelines is designed to provide third party access to natural gas transmission and distribution pipelines where access would otherwise be constrained by the misuse of market power.
- Australia's natural gas sector has experienced major reforms, structural change and growth over the last decade.
 - Although competition is emerging (in part due to greater connectivity), a gas access regime of some type is still warranted.
- The current Gas Access Regime, in effect, is a form of cost-based price regulation. While generating benefits, its significant costs include a potential to distort investment.
- A key recommendation is the addition of a less costly, monitoring option.
- The choice between price regulation and monitoring for each covered pipeline would be based on which was assessed as generating the greater net economic benefits.
 - Price regulation would only apply when the net benefits would be markedly greater than those of the monitoring option.
- Other recommendations include:
 - sharpening the specification of the objectives of the regime by inserting an overarching objects clause with a focus on promoting efficiency and by removing inappropriate and conflicting objectives scattered through the regime
 - changing the test for coverage
 - replacing the current guidelines for approving reference tariffs with a clear set of pricing principles
 - including scope to use non-building block approaches to setting reference tariffs.
- The recommended objects clause, coverage criteria and pricing principles have also been worded to be consistent with the Australian Government's proposed changes to the national access regime.
- To make the regime conform with the above recommendations, considerable streamlining is recommended for the detailed guidance for determining access arrangements and reference tariffs and for dispute resolution.
- To reduce the potential chilling effect of the regulation on greenfield investments, it is proposed that there be scope in the Gas Access Regime for a binding ruling of 'no coverage' for 15 years, on a case-by-case basis.
 - It would apply to proposed pipelines that do not meet the coverage criteria.
- Implementing the recommendations would enable the benefits of access regulation to be achieved at lower cost to the economy.

Overview

The National Third Party Access Regime for Natural Gas Pipelines (the Gas Access Regime) is an industry-specific regime for third party access to natural gas transmission and distribution pipelines. A key element of the regime is the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code), which was agreed to by the Council of Australian Governments (COAG) in 1997. The national regime is implemented by each State and Territory incorporating the Gas Code into its own gas access law. Although many key requirements are common across States and Territories, there are some differences, including such matters as establishing jurisdictional regulators and arbitrators that can lead to regulatory divergences.

The Commission has been asked to review the regime with the primary aim of examining the extent to which the Gas Access Regime balances the interests of relevant parties, provides a framework that enables efficient investment in pipelines and network infrastructure and facilitates the development of competition in the natural gas market. The Commission also has been asked to identify what the minimum (price and non price) requirements in the Gas Code would be to achieve the third party access objective.

The Commission's review is being undertaken within the framework of the national access regime (part IIIA of the *Trade Practices Act 1974*), clause 6 of the Competition Principles Agreement 1995, the National Energy Policy Framework agreed to by COAG in June 2001 and recent policy statements by the Ministerial Council on Energy. The Commission is also required to take into consideration the Australian Government's response to the Commission's review of the national access regime and outcomes arising from the COAG Energy Market Review (Parer report).

Gas Access Regime

The Gas Access Regime applies to natural gas transmission and distribution pipelines (box 1).

Initially, 22 transmission pipeline systems and 14 distribution networks were automatically covered by being listed in schedule A of the Gas Code. Since then,

one new transmission pipeline and three new distribution networks have been covered.

Box 1 Gas Access Regime

The Gas Access Regime only applies to pipelines that are 'covered' under the regime.

There are four ways a pipeline may be covered:

- Listed in schedule A of the Gas Code, which was approved by COAG in 1997.
- A service provider requests coverage and has an access arrangement approved by the relevant regulator.
- The relevant Minister decides to cover, following a recommendation from the National Competition Council and a request for coverage by any person.
- Where the outcome of a competitive tender process for a new pipeline is approved by the relevant regulator.

Once a pipeline is covered, a service provider is required to have an access arrangement approved by the relevant regulator (Australian Competition and Consumer Commission or relevant State or Territory regulator). Guidelines for access arrangements are set out in the Gas Code, such as the conditions under which access will be offered (including prices), policies relevant to the operation and extension of a pipeline, and a review date.

A service provider and access seeker are free to agree on terms and conditions that differ from those in the access arrangement. However, if an access dispute about a reference service arises, the arbitrator (relevant regulator or nominee) is required to impose the default terms and conditions set out in the access arrangement (for example, price will be set to the relevant reference service tariff). There are mechanisms for appealing decisions, including those on coverage and access arrangements.

The relevant Minister can revoke coverage of a pipeline, following an application for revocation by any person and a recommendation by the National Competition Council.

Coverage for 13 transmission systems (or parts thereof) and six distribution networks has been revoked. There has been one decision to cover that was subsequently overturned by the Australian Competition Tribunal. Twenty-two of the 24 transmission and distribution systems currently covered have approved access arrangements in place. Although coverage has been revoked for a number of pipelines, most of the major pipelines remain covered.

Not all throughput of a covered pipeline is subject to regulated prices. In the case of transmission pipelines, a major proportion of throughput is priced according to foundation and other contracts established prior to the advent of the Gas Access Regime and therefore not yet influenced by the regulation. In the case of

distribution networks, most throughput is purchased through contracts based on regulated prices. In the future, the influence of regulated prices is expected to increase as old contracts expire and new contracts are negotiated.

Is there a case for a gas access regime?

Potential for market power that inhibits competition

Natural gas transmission and distribution pipelines exhibit ‘natural monopoly’ characteristics — one pipeline system can transport gas along a specific route more cheaply than two or more independent systems. In an unregulated situation, there is potential for the operator of such a pipeline system to have substantial and enduring market power. Such market power can be used to inhibit competition in upstream and downstream markets by denying third party access to the transportation services of the pipeline system or by imposing terms and conditions on access (including price). Such market power can also be used to charge high prices, leading to inefficiencies in the gas market.

At the time the Gas Code was being developed, the Australian gas market was characterised by vertically integrated, public monopolies. There was concern by governments that utilities could use their market power to inhibit competition. Consequently, COAG agreed to introduce a uniform regulatory approach to promote competition in the gas market.

Other competitive forces

The existence of gas pipelines that exhibit natural monopoly characteristics is insufficient to conclude that these pipelines have enduring market power which can be misused. Consideration also needs to be given to the nature of the demand characteristics for the services of pipelines. A number of competitive forces and factors can impact on demand and constrain market power.

The demand for gas is derived from the demand for the goods or services produced using natural gas as an input. Gas is often supplied to industries that produce commodities sold in competitive markets (such as mineral processing and electricity generation). In such industries, end use might be sensitive to the transportation price. New pipelines (both transmission and distribution) are often developed in contestable markets, where they compete vigorously to secure sufficient load for the pipeline from prospective users. For transmission pipelines, securing such load helps to reduce both the developer’s exposure to risk and to underwrite investment.

In addition, large end users might represent a large proportion of the pipeline's capacity and therefore might have significant, countervailing bargaining power. Further, gas often has other close substitutes in end use, such as coal, electricity, LPG, oil and distillate, particularly in the case of distribution networks.

In the above circumstances, a rise in the relative price of gas could result in a significant loss of sales and a decrease in profit, particularly in the medium and long term, as users replace gas consumption with a substitute. Consequently, pipeline operators can find the exercising of market power unsustainable.

Emerging pipeline competition

The nature of the gas market has changed markedly since the commencement of the reforms in the early nineties. Many of the vertically integrated public gas utilities have been structurally disaggregated and the separated entities privatised. Retail competition is being progressively introduced in most jurisdictions. There is emerging competition between independent gas basins and between transmission pipelines servicing specific markets, such as Adelaide and Sydney. As the interconnectivity of the gas transmission network has increased, the dynamic nature of, and the market opportunities in, the sector have also increased. There is potential for relatively small investments in interconnecting pipelines to increase the level of competition and to change how gas moves between sources of supply and end use markets. This trend is expected to continue as the transmission system in eastern Australia continues to become increasingly integrated.

A gas access regime is still warranted

Although many participants have substantial concerns about the current regime, there is widespread acceptance of the need for some form of access regime for gas pipelines.

Participants expressed strongly a range of views about the Gas Access Regime. The views typically reflected their interest. Gas users, in general, consider that the regime has been beneficial and has delivered them lower prices. A number of regulators were of the view that, despite the transitional costs of implementation, there have been substantial benefits and likely to be greater benefits realised in the future. The views of gas producers varied. Although service providers acknowledge there have been significant benefits from gas reform and the Gas Access Regime, they consider there are a number of significant deficiencies in the regime that need to be addressed. Although competition is increasing in a number of areas, the gas

market is still in transition and competition has not reached a level where a gas access regime is no longer warranted.

The Commission considers that the original arguments put forward for a gas industry-specific access regime are still valid at this time and are likely to remain so for some time. A number of pipelines are still likely to warrant regulation. There is likely to be more than one access seeker for some pipelines (particularly for gas distribution networks). A generally available access arrangement for such pipelines is likely to involve lower costs than requiring each access seeker to seek access through the negotiate–arbitrate framework of the national access regime (part IIIA of the Trade Practices Act). Consequently, the Commission considers that an industry-specific national access regime for gas transmission and distribution pipelines is still warranted.

The challenge is to design a gas access regime that encourages and strengthens the development of competition and innovation, and also imposes forms of regulatory intervention only where they are likely to generate net economic benefits.

What are the problems with the current regime?

Quantifying the benefits and costs of the Gas Access Regime is extremely difficult, particularly in the absence of information about what would have occurred without the regime (the counterfactual). This is even more difficult because, while most of the significant pipelines are covered, much of the gas transported is delivered under long-term contracts and is not directly regulated, there are other dynamic competitive forces at work as competition emerges, and other policy influences are simultaneously at work.

The Commission has not attempted to undertake a formal cost–benefit analysis of the impact of the Gas Access Regime using models, such as general equilibrium models. The uncertainties about relevant (access regime specific) data (including variations across jurisdictions and across end-users), behavioural relationships and counterfactual scenarios to be input into such models, would cast considerable doubt about the conclusions which could reasonably be drawn from such modelling. Further, such modelling would bring little clarity to deciding on whether and how to improve the existing regime.

Based on the Commission’s assessment (of both costs and benefits), including taking into account input from interested parties, it is reasonable to conclude that there are problems with the current regime. These mainly arise from the considerable costs the regime imposes and its real potential to distort investment and inhibit innovation.

The characteristics of the current regime that lead to these high costs are briefly outlined below.

Too great a focus on cost-based price regulation

The original approach for access regulation (as reflected in the Competition Principles Agreement and subsequent enactment of the national access regime) was to promote competition in upstream and downstream markets. This was to be achieved by establishing a legal right for third parties to negotiate access to the services of essential facilities (such as gas transmission and distribution pipelines). The approach included scope for variations in the terms and conditions for third party access, based around a negotiate–arbitrate framework.

Although the Gas Access Regime appears to be based on a negotiate–arbitrate framework, third party access prices, in effect, are determined using cost-based price regulation. This outcome arises because of the fundamental role attached to reference tariffs in the event of a dispute over access to a reference service and the way in which tariffs for reference services must be determined under the regime.

The service provider of a covered pipeline must put in place an access arrangement containing reference tariffs for one or more reference services that are likely to be sought by a significant part of the market. If there is an unresolved dispute over the price of a reference service, the arbitrator (relevant regulator) must require the service provider and user to accept the reference tariff of a reference service.

In approving the reference tariff, the regulator must ensure that it complies with the reference tariff principles, which essentially require tariffs to be based on estimated efficient costs of supply. Under the regime, regulators are required to replicate the outcome of a competitive market. This is an unachievable task and one which inherently involves substantial regulatory risk and scope for error, particularly given the emergence of competition and the potential impact of competitive forces in constraining the sustainable misuse of market power.

The outcome has been that third party access is essentially based on the regulator approved cost-based reference tariffs. There is a high degree of risk that the price set by the regulator is no more efficient than that which would have prevailed in the absence of price regulation, particularly given the other deficiencies in the regulation discussed below. There is a prospect that the regulation of prices is leading to a distortion in investment (towards lower risk projects) and delaying the development of new pipelines, which then slows down the emergence of competition in related energy markets and between pipelines.

Too many conflicting objectives within the gas access law

There is a lack of clarity in the legislation about its objectives. Although the preamble, which is based on the objectives set out in the Natural Gas Pipelines Access Agreement 1997, can be used to imply objectives, the regime has no objects clause. Moreover, the regime has complex sets of principles and factors to be taken into account by the regulators in approving an access arrangement, reference tariffs and dispute arbitration. Further, regulators may take ‘other factors’ into account that they consider relevant (factors not mentioned in the Gas Code) in approving an access arrangement.

The Supreme Court of Western Australia, in a judicial review of the Western Australian regulator’s draft decision on the proposed access arrangement for the Dampier–Bunbury pipeline, concluded that there was tension between the many objectives requiring resolution by the regulator.

It is common practice for regulators (and the courts) to be given some discretion to take into account factors that might vary from case to case. However, for the Gas Access Regime, the Commission has concluded there are too many objectives, some of which are in conflict and some of which do not appear directly relevant to the overall policy objective of the regulation.

A range of methods can be applied

In addition to the wide range of factors and principles to be considered, the Gas Code sets out various methods that can be applied to determine reference tariffs, rate of return, depreciation, and incentive mechanisms. Different interests usually seek to have the values of such parameters set in a way that favours their own circumstances.

Wide discretionary powers of regulators

The Gas Access Regime provides regulators with wide discretionary powers in approving access arrangements. Regulators are able to attach any weight they consider relevant when weighing up conflicting factors and principles. This leads to regulatory uncertainty as the weights attached to factors can vary on a case-by-case basis. The regime also provides regulators with discretionary powers to extend the time taken to finalise access arrangements.

Although some degree of discretion is appropriate, the Gas Access Regime provides virtually unlimited discretion. This aspect of the regime is exacerbated by the wide

range of objectives given to regulators. It leads to widely different stakeholder expectations about the regulatory outcomes achievable, thereby creating stronger incentives for disputation, uncertainty and a high probability of inconsistency in the application of the regulation.

High information and research costs

Regulators seek a large amount of detailed information from service providers and users. They also commission or undertake a substantial amount of research. In this way, service providers and regulators can incur large costs. Principally, regulators require the information to satisfy themselves that they have discharged their responsibilities in relation to approving and determining reference tariffs, in accordance with the flexible and highly discretionary framework set out in the regime. The outcome is the intrusive and meticulous use of the ‘building block’ cost method and incentive regulation framework to set reference tariffs with a false sense of precision.

Too many regulatory decisions

A service provider has to go through two decisions (draft and final) by the relevant regulator, and frequently a third (further final), possibly ending with the regulator drafting and approving the access arrangement. Both the draft and final decisions involve public consultation, which takes time. All these decisions have to be made before a merits appeal can be initiated. When the service provider and regulator fundamentally disagree, there are four stages for determining an approved access arrangement (including the merits appeal). This process extends unnecessarily the time to get an access arrangement approved when there is disagreement between the regulator and the service provider.

Number of jurisdictional bodies approving access arrangements

There are a large number of regulatory and merits appeal bodies, principally because State and Territory jurisdictions initially wanted sovereignty of distribution network regulation. There are two regulators and two merits appeal bodies dealing with transmission pipelines. In the case of gas distribution, there are eight regulators and five merits appeal bodies. The large number of regulators and merits appeal bodies can create the potential for inconsistent outcomes and increase regulatory risk for service providers and third party access seekers. This issue will be partly addressed by the decision of the Ministerial Council on Energy to establish a national energy regulator, which will assume responsibilities for gas transmission

and distribution in all jurisdictions other than Western Australia (which may ultimately also join).

Governance arrangements

There has been concern by some participants about the effectiveness of the institutional arrangements to manage changes to the Gas Code. The Natural Gas Pipelines Advisory Committee is not working well. Significant reform of this committee is necessary. However, this issue would seem to be addressed by the recent decision of the Ministerial Council on Energy to establish the Australian Energy Market Commission, which will be responsible for managing rule making, including code changes, for electricity and ultimately gas.

Impact of the regime on investment

Service providers argued that the Gas Access Regime distorts pipeline investment. On the other hand, a number of users and regulators provided data on the substantial investment in pipelines since the inception of the regime.

It is difficult to draw conclusions from the information provided by inquiry participants because the ‘no regulation’ scenario is unobservable. Projects that did not proceed might not have been viable in any event. On the other hand, observing actual investment does not prove that investment has not been distorted. For example, growing gas demand probably would have led to some investment taking place in any event.

In addition, the impact on investment of other reforms to the gas sector and additional factors, such as the discovery of new gas fields, cannot be easily separated from those of the regime.

In light of the above, the Commission considers that an assessment of the effects of the regime on investment must include not only the possible positive effects on investment, but also an examination of the likelihood of cost-based price regulation being applied to pipelines with little or no market power, regulatory error occurring in approving and determining cost-based regulated prices, and the existence of regulatory risk from uncertainty about how regulation might be applied.

As noted previously, gas pipelines have natural monopoly characteristics but, in some circumstances, the potential to exercise market power might be constrained. Thus, for some pipelines, the benefits of relying on cost-based regulated prices as the principal instrument for achieving the benefits arising from third party access might be small and difficult to realise in practice. The Commission considers that

this is a possibility under the regime because the current coverage test sets too low a threshold for cost-based price regulation.

The Commission also considers that there is a potential for *regulatory error* under the regime due to the complex issues involved in determining a reference tariff, including the need to make a subjective judgment about the risk faced by a service provider. Where regulatory errors do occur under the regime, there is a possibility that they reduce expected returns for riskier projects below those necessary for efficient investment. For example, the expected rate of return allowed by regulators has been based on the precedents set for established, possibly lower risk, pipelines. In addition, recent appeal decisions suggest that regulators err towards imposing lower returns.

The Commission considers that *regulatory risk* can be high under the regime due to the fact that a new pipeline might be covered at some future time. There is also uncertainty about the values of various parameters a regulator might apply in approving reference tariffs (such as the weighted average cost of capital) and uncertainty about future decisions that could lead to redundant capital. Evidence of asymmetric truncation (capping high profits) is not as clear cut, due to the limited number of access arrangement reviews to date. Nevertheless, the Commission considers that investors will anticipate asymmetric truncation under the Gas Access Regime, particularly for riskier projects, because of:

- the difficulty regulators have in distinguishing between higher returns on risky projects and monopoly returns, after the investment has been made
- the incentives regulators can face to reduce any high profits observed after the investment has been made.

The Australian Competition and Consumer Commission has issued a draft greenfields guideline to address perceptions that there is regulatory risk under the regime and that regulators asymmetrically truncate profits. However, the Commission considers that this guideline does not substantially alter the potential for investment to be distorted. The guideline is only a draft — and has been so for at least two years — and it maintains the wide discretion that the Gas Code gives to regulators to set key regulatory parameters.

The effect of the Gas Access Regime on future investment might also arise through its indirect effect on foundation customers, even though the regime only applies to third party access and excludes foundation customer contracts in place prior to coverage. New transmission projects generally require simultaneous large, long-term investments to be made by gas producers in production facilities, by service providers in pipelines and by foundation customers in large industrial processes or power generation. Foundation customers play an important role in the

development of transmission pipelines, providing a way to share the risks across all those involved. The regulator could set regulated access prices (reference tariffs) that are below the prices agreed to by foundation customers of the pipeline. The third party access seekers might also be competitors of the foundation customers and receive a competitive advantage by way of being a third party access seeker. In this environment, it is reasonable to expect future foundation customers to include clauses in their contracts that ensure they are not commercially disadvantaged by third party access and are able to share in any future cost reductions arising from the exploitation of economies of scale.

The Commission considers that the Gas Access Regime is likely to distort investment in favour of lower risk projects. This could result in a greater reliance than otherwise on building capacity that is essentially fully contracted, expanding capacity incrementally and delaying pipeline construction until forecast demand is more certain.

What changes are required?

A full list of the Commission's findings and recommendations follow this overview. They set out the Commission's recommendations on the way to improve the operation of the regime. A key change being proposed by the Commission is the addition of a new light-handed regulation option (a monitoring regime). Some of the more important recommendations are discussed below.

Include an objects clause

Inclusion of an overarching objects clause is highly desirable to clarify the policy intent of the regime; guide and improve the accountability of Ministers, regulators, arbitrators, tribunals and courts; provide greater certainty to service providers and access seekers about possible regulatory intervention; and promote national consistency (both across jurisdictions and between access regimes).

The recommended overarching objective of the regime is 'to promote the economically efficient operation and use of, and economically efficient investment in, the services of transmission pipelines and distribution networks, thereby promoting effective competition in upstream and downstream markets'. The objects clause is essentially the same as that proposed by the Australian Government for the national access regime. The Commission considers it important to have the two regimes consistent.

The Commission recommends modifications and deletions to other sections of the Gas Code to remove any unwarranted, conflicting objectives. The changes affect the criteria and guidance in sections dealing with access arrangements, reference tariffs and dispute resolution.

Modification of the coverage criteria

The Commission recommends that the (revised) coverage criteria for the Gas Access Regime (box 2) be essentially the same as the Australian Government's proposed declaration criteria for the national access regime. Consistency is important. Adopting a matching set of coverage and declaration criteria for the two regimes avoids overlap, ensuring that the Gas Access Regime has primacy for gas transmission and distribution pipelines. Therefore, a pipeline not covered under the Gas Access Regime also would not be declared under the national access regime.

Box 2 Recommended coverage criteria for the Gas Code

The Commission recommends replacing s.1.9 of the Gas Code with the following proposed coverage criteria:

Subject to sections 1.4(a) and 1.10, the NCC [National Competition Council] must recommend that the Pipeline be Covered (either to the extent described, or to a greater or lesser extent than that described, in the application) if the NCC is satisfied of all of the following matters, and cannot recommend the Pipeline be Covered, to any extent, if the NCC is not satisfied of one or more of the following matters:

- (a) that access (or increased access) to Services provided by means of the Pipeline would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline;
- (b) that it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline;
- (c) that access (or increased access) to the Services provided by means of the Pipeline can be provided without undue risk to human health or safety; and
- (d) that access (or increased access) to the Services provided by means of the Pipeline would not be contrary to the public interest.

Modification of access arrangement provisions

The Commission has made a number of recommendations in relation to access arrangements and reference tariffs in particular. A key recommendation is the replacement of the existing general objectives to be achieved by regulators in approving reference tariffs with a more specific and operational set of pricing principles (box 3). These principles are essentially the same as those proposed by

the Australian Government for inclusion in the national access regime. Once again, consistency is important.

Box 3 Recommended pricing principles

The Commission recommends replacing s.8.1 of the Gas Code with the following:

A reference tariff or reference tariff policy should be designed with regard to the overarching objects clause, s.2.24 and the following principles:

- (a) that reference tariffs should:
 - (i) be set so as to generate expected revenue for a reference service or services that is at least sufficient to meet the efficient costs of providing access to the reference service or services
 - (ii) include a return on investment commensurate with the regulatory and commercial risks involved
- (b) that reference tariff structures should:
 - (i) allow multi-part pricing and price discrimination when it aids efficiency
 - (ii) not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to non-associates is higher
- (c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.

The Commission also recommends that service providers be able to apply methods other than the ‘building block’ approach to design reference tariffs, provided they are consistent with the objects clause and pricing principles. The Commission also recommends deletions and amendments to other sections of the Gas Code to make them consistent with the policy intent behind the objects clause and pricing principles. The recommended modifications of guidelines for access arrangements are designed to maintain the benefits of, and reduce the economic costs associated with, the application of price regulation.

Addition of a monitoring option

The Commission considers that the existing regime leads to the application of cost-based price regulation (through the application of reference tariffs) in situations where it is doubtful that it maximises net benefits to the economy, after taking into account the economic costs of regulation.

The Commission appreciates that the gas market is in transition and there is still uncertainty about the potential for competition in many areas. However, looking forward, the gas market is likely to become increasingly dynamic as

interconnectivity increases, basin on basin competition develops and gas producers and users respond to the commercial opportunities generated by these changes.

In this situation, the Commission considers there is merit in introducing a monitoring option to be applied to those covered pipelines that meet certain requirements. The features of the monitoring option would include:

- a service provider prescribed third party access policy
- subjecting service providers to the anticompetitive conduct provisions of the existing regime
- a service provider prescribed framework for negotiation and binding arbitration in the event of dispute over access
- subjecting monitored pipelines to some of the ring fencing provisions that currently apply to covered pipelines
- public disclosure of specified information for monitoring purposes only
- scope for the service provider to implement additional features such as a voluntary code of conduct.

Service providers, at their discretion, would set out in their access policy the procedures and any terms and conditions for gaining access and the way they propose to handle matters relating to queuing, capacity trading and expansion.

In part, the effectiveness of the monitoring regime depends upon the threat of price regulation involving an access arrangement with reference tariffs. The Commission recommends that monitoring be applied for a minimum of five years to give parties incentives to negotiate commercially. After the initial five-year monitoring period, the relevant Minister would be able to decide that regulation involving an access arrangement with reference tariffs should apply. The relevant Minister's decision would need to be preceded by a recommendation from the National Competition Council on the form of regulation to apply, which only the regulator responsible for oversight of monitoring would be able to request.

Inclusion of a formal monitoring option provides a way of keeping some covered pipelines out of price regulation in situations where the case to apply price regulation is not strong, but the relevant Minister considers it would be inappropriate not to cover the pipeline. It also offers a practical way of making the transition from price regulation to no regulation in a phased way. Further, it enables the costs of price regulation to be avoided, while providing users with a degree of confidence that the behaviour of service providers is being 'watched' and still facilitating third party access. In other words, it enables the benefits of the existing regime to be achieved, but at a lower cost to the economy.

The Commission has made a number of recommendations on how to incorporate the monitoring option into the Gas Access Regime, including suggestions on how to discourage its development into an intrusive and costly form of regulation.

The Commission recommends that an assessment of net economic benefits be used in deciding on which form of regulation should apply (that is, between monitoring and price regulation involving an access arrangement with reference tariffs). This choice would depend on which form of regulation generates greater net benefits. An access arrangement with reference tariffs would only apply where the net benefits are markedly above those for the monitoring option. The Commission recommends the inclusion of specific factors in the Gas Access Regime to be used by both the Minister in deciding on, and the National Competition Council in recommending on, the form of regulation to apply to covered pipelines.

To deal with transitional matters, the Commission recommends that at the time the new regime comes into effect, the coverage status and form of regulation initially would be the same as those applying under the old regime.

The framework for decisions on coverage and the form of regulation is depicted in figure 1. Applications for coverage or revocation would occur on a case-by-case basis. Any person can apply for revocation at any stage. Any person can apply for coverage of an uncovered pipeline at any stage. For monitored pipelines, only the regulator responsible for administration of monitoring can apply for a move to price regulation at any time after each five-year monitoring term. This review process for a monitored pipeline could lead to a decision to continue monitoring for five years, or a move to price regulation.

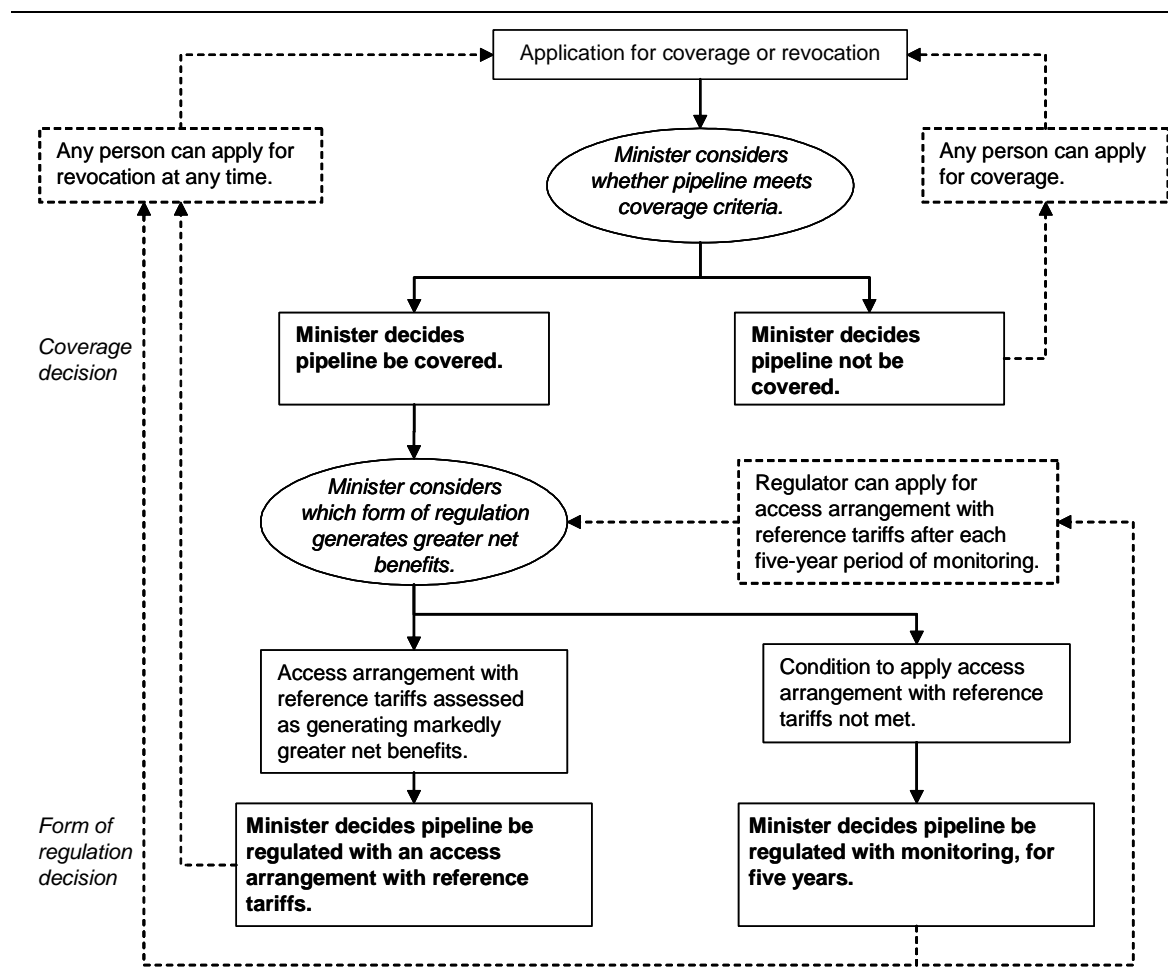
Institutional arrangements

The Commission recommends that the agency responsible for making recommendations on coverage and the form of access regulation (monitoring or price regulation involving an access arrangement with reference tariffs) to the relevant Minister should be separate to, and independent of, the agency responsible for administering the forms of regulation to be applied under coverage.

Certification of the new regime

Certification that the Gas Access Regime is an effective regime within the context of the national access regime is important. Certification by the Minister, following a recommendation from the National Competition Council, ensures the primacy of the Gas Access Regime over the national access regime for covered gas pipelines and prevents regulatory forum shopping.

Figure 1 **Proposed framework for deciding coverage and form of regulation^a**



^a The National Competition Council follows an identical process in recommending to the Minister whether a pipeline should be covered, and if so, what form of regulation should apply.

The National Competition Council, in commenting on the Commission's proposal set out in the draft report, raised issues about whether the proposed Gas Access Regime could be certified effective (that is, consistent with the Competition Principles Agreement). The main concern related to the absence of provisions for negotiation and binding arbitration under the then proposed monitoring option.

The Commission recommends that under the monitoring form of regulation, service providers be required to prescribe a framework for commercial negotiation and binding arbitration. Further, as described earlier, it would be possible for the relevant Minister to decide to subject the monitored pipeline to price regulation involving an access arrangement with reference tariffs at the end of its five-year monitoring period. Under this latter form of regulation there is already provision for binding arbitration, with the regulator (or its nominee) acting as the arbitrator.

The Commission considers that, given the characteristics of the now recommended regime, it is likely that the Minister and the National Competition Council would assess the new regime as effective. However, the situation will remain uncertain until the Minister and the National Competition Council formally consider certification of the new regime. In light of this uncertainty, the Commission recommends that clause 6 of the Competition Principles Agreement be modified as recommended by the Commission in its review of the national access regime (box 4). The Australian Government, in its response to the Commission's report, supported the recommendation to modify clause 6 of the Competition Principles Agreement.

Box 4 Commission's finding on criteria to assess the effectiveness of State and Territory access regimes

Ideally an 'effective' access regime should include the following:

- an objects clause (specifying that the objective of the regime is to promote the efficient use of, and investment in, the essential infrastructure facilities concerned)
- coverage arrangements that focus mainly on services for which it would be uneconomic to develop another facility to provide the service
- clearly specified dispute resolution arrangements and provisions to establish the terms and conditions of access
- clearly specified criteria and pricing principles applying to regulated terms and conditions
- effective appeal and enforcement provisions
- revocation and review requirements for all determinations
- where relevant, provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service
- where relevant, provision for measures to facilitate efficient new investment.

The degree of reliance on negotiation, relative to arbitration and regulation, to set terms and conditions of access should be a matter for individual regimes and not be a part of the effectiveness test.

Binding no-coverage rulings

At present, the National Competition Council can only offer informal, *nonbinding* advice to potential investors about whether a specific pipeline project would satisfy the coverage criteria. To help reduce regulatory risk for some new pipelines prior to the investment commitment, the Commission recommends that the Minister be able to provide a binding ruling of no coverage for a period of 15 years, following a

recommendation by the National Competition Council. The binding ruling would be applied to proposed pipeline projects that would not satisfy the coverage criteria.

How would the changes benefit the community?

Adoption of the Commission's recommendations would deliver more efficient outcomes, particularly in relation to investment in the gas sector and the development of a competitive energy market. The recommendations would reduce regulatory risk, potential for regulatory error and the time and cost of regulatory procedures and improve regulatory accountability. The recommendations are designed to achieve the benefits of the existing regime while reducing many of its costs.

Findings and recommendations

Australian gas industry

FINDING 2.1

Transmission pipelines have natural monopoly characteristics. The scope for transmission pipeline owners to exercise market power arising from such characteristics can be constrained by a number of factors, including:

- the availability of substitutes — that is, the presence of a competing pipeline in the end market and/or of substitute fuel and energy sources*
- the size and concentration of users and the competitive nature of foundation contracts*
- the elasticity of demand for the final products, for which natural gas is an input.*

The extent to which these factors constrain market power differs across pipelines.

FINDING 2.2

Distribution networks have natural monopoly characteristics. The scope for distribution network owners to exercise market power arising from such characteristics can be constrained by a number of factors, including the availability of other fuel and energy substitutes. The extent to which market power is constrained differs across networks. A network owner servicing a new market (or one in which use is low) generally has little market power.

FINDING 2.3

The market conditions facing the gas transmission and distribution sectors have changed since the Gas Access Regime was developed. In the transmission sector participants are increasingly having to respond to new opportunities that arise in an emerging competitive market. Competition in this sector is expected to increase further through even greater connectivity. The gas distribution sector is also facing more competitive market conditions arising, in particular, from a more competitive electricity sector. Notwithstanding these changes, the gas market is still in transition. In this environment, some form of a gas access regime is still warranted.

Gas Access Regime

FINDING 3.1

The Gas Access Regime is a form of price regulation based on a cost-of-service model. It is, therefore, at the more intrusive end of regulation.

Is the Gas Access Regime working?

FINDING 4.1

An industry-specific access regime is appropriate for gas transmission pipelines and distribution networks because of its advantages over the negotiate–arbitrate model of the national access regime.

FINDING 4.2

The Gas Access Regime has delivered benefits through determining the terms of third party access to pipelines and facilitating competition in upstream and downstream markets.

FINDING 4.3

The Gas Access Regime is likely to be distorting investment in favour of less risky projects, including altering the nature and timing of pipeline investments. Pipeline construction might be delayed, for example, and there might be greater emphasis on building capacity that is essentially fully contracted prior to construction. Such alterations can inhibit the emergence of competition in upstream and downstream markets and generate inefficiencies.

FINDING 4.4

Information provided by interested parties supports the view that the Gas Access Regime might have a discouraging effect on innovation and improvements in service offerings.

FINDING 4.5

Generally, cost-based price regulation should be considered only if service providers have substantial market power. Where market power is not strong, such as where there is emerging competition, in the long run the costs of regulated prices are likely to outweigh the cost of the market failure that such regulation attempts to correct.

FINDING 4.6

There are significant compliance and administration costs in the operation of the Gas Access Regime. Delays in decision making have added to the costs.

FINDING 4.7

The existing Gas Access Regime has deficiencies. Improvements are possible.

Objectives and objectives clause

FINDING 5.1

There is a need to specify more clearly the objectives of the Gas Access Regime.

FINDING 5.2

The incorporation of an overarching objects clause into the Gas Access Regime legislation would enhance the effectiveness of the regime.

RECOMMENDATION 5.1

The following overarching objects clause should be incorporated into the Gas Access Regime, with the wording consistent with the Australian Government's proposed objects clause for the national access regime:

To promote the economically efficient operation and use of, and economically efficient investment in, the services of transmission pipelines and distribution networks, thereby promoting effective competition in upstream and downstream markets.

RECOMMENDATION 5.2

For decisions about coverage, the form of regulation and regulated access terms and conditions, the relevant decision maker should be explicitly guided by the overarching objects clause.

RECOMMENDATION 5.3

With the implementation of recommendation 5.1, the following objectives in the preamble to the existing legislation and the related objectives in the introduction to the Gas Code should be deleted:

- (a) facilitates the development and operation of a national market for natural gas***
- (b) prevents abuse of market power***

-
- (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders*
 - (d) provides for rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines*
 - (e) provides for the resolution of disputes.*

FINDING 5.3

The following elements of s.2.24 of the Gas Code are necessary to provide guidance for regulators when assessing access arrangements and should be retained:

- (b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline*
- (c) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline.*

RECOMMENDATION 5.4

The following elements of s.2.24 of the Gas Code do not provide necessary guidance to regulators when assessing access arrangements and should be deleted:

- (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline*
- (d) the economically efficient operation of the Covered Pipeline*
- (e) the public interest, including the public interest in having competition in markets (whether or not in Australia)*
- (f) the interests of Users and Prospective Users*
- (g) any other matters that the Relevant Regulator considers are relevant.*

FINDING 5.4

The following elements of s.6.15 of the Gas Code are necessary to provide guidance for arbitrators when arbitrating disputes over access arrangements and should be retained:

- (e) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline*
- (f) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline.*

The following elements of s.6.15 of the Gas Code do not provide necessary guidance to arbitrators when arbitrating disputes over access arrangements and should be deleted:

- (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline*
- (b) the costs to the Service Provider of providing access, including any costs of extending the Covered Pipeline, but not costs associated with losses arising from increased competition in upstream or downstream markets*
- (c) the economic value to the Service Provider of any additional investment that the Prospective User or the Service Provider has agreed to undertake*
- (d) the interests of all Users*
- (g) the economically efficient operation of the Covered Pipeline*
- (h) the benefit to the public from having competitive markets.*

An additional factor should be added to s.6.15 of the Gas Code, as follows:

In the event of a dispute about the price of access to a non-reference service, the arbitrator should be guided by the pricing principles in s.8.1 of the Gas Code (as revised by recommendation 7.1).

Coverage issues

It is important that the coverage process and criteria are designed so that regulatory intervention occurs only in those circumstances in which it is likely the benefits of regulation outweigh its costs.

Different coverage criteria for transmission pipelines and distribution networks are not warranted. The coverage criteria should be sufficiently flexible to deal with such differing circumstances.

FINDING 6.3

If the threshold for coverage under the Gas Access Regime were higher than that for declaration in the national access regime, pipelines that do not satisfy the coverage criteria under the Gas Access Regime could be declared under the national access regime if they were to satisfy the declaration criteria.

FINDING 6.4

In circumstances of there being a specific Gas Access Regime, it is desirable for this regime to have primacy over the national access regime.

RECOMMENDATION 6.1

The Gas Access Regime coverage criteria should provide the same threshold for coverage as declaration under the national access regime, such that a pipeline not satisfying the coverage criteria of the Gas Access Regime also will not satisfy the declaration criteria of the national access regime.

RECOMMENDATION 6.2

The first criterion for assessing coverage (s.1.9[a] of the Gas Code) should be amended to reflect the Australian Government's proposed change to s.44G(2)(a) in part IIIA of the Trade Practices Act (the national access regime). That is, that the National Competition Council would need to be satisfied:

(a) that access (or increased access) to Services provided by means of the Pipeline would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.

The Minister would also be bound by this change as per s.1.15 of the Gas Code.

FINDING 6.5

The following criteria should be retained in the coverage criteria (s.1.9 of the Gas Code):

- (b) that it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline*
- (c) that access (or increased access) to the Services provided by means of the Pipeline can be provided without undue risk to human health or safety*
- (d) that access (or increased access) to the Services provided by means of the Pipeline would not be contrary to the public interest.*

RECOMMENDATION 6.3

The Gas Access Regime should be modified such that the Minister and National Competition Council, in making a decision and recommendation, respectively, to cover a pipeline, should also decide and recommend, respectively, the form of regulation to apply.

RECOMMENDATION 6.4

The decision and recommendation on the form of regulation to apply should be based on an assessment of the net benefits to the economy of each form of regulation (an access arrangement with reference tariffs or monitoring option). Access arrangements with reference tariffs should be applied only where the net benefits of its application are markedly greater than the net benefits of the monitoring option. Otherwise the monitoring option should be applied.

FINDING 6.6

There would be benefits from improved consistency and reduced uncertainty if the Minister and the National Competition Council were provided with guidance on the matters to be considered when deciding and recommending, respectively, which form of regulation should apply.

RECOMMENDATION 6.5

The Gas Access Regime should be amended to give guidance on matters that the Minister and the National Competition Council should consider in deciding and recommending, respectively, which form of regulation should apply to a covered pipeline.

In determining the potential benefits of either form of regulation, the following matters should be taken into account:

- (a) the nature of demand for the commodities and services of end users of gas*
- (b) the actual and potential level of competition from substitutes such as gas from other sources delivered through other pipelines, and other forms of energy such as electricity*
- (c) the nature and extent of any barriers to entry in the market*
- (d) the degree of countervailing power in the market*
- (e) the degree of horizontal and vertical integration*
- (f) any other significant factors, subject to them being consistent with the proposed new objects clause.*

In determining the potential costs of either form of regulation, the following matters should be taken into account:

- (a) direct costs of service providers, governments and users*
- (b) other costs (for example, distortions in behaviour arising from timeliness, regulatory risk and regulatory error (such as the inherent difficulties in determining efficient costs for services))*
- (c) any other significant factors, subject to them being consistent with the proposed new objects clause.*

RECOMMENDATION 6.6

The Gas Access Regime should be amended to provide that where a service provider potentially covered by the Gas Code lodges a part IIIA undertaking, this should trigger an assessment (currently by the National Competition Council) and decision (by the Minister) on whether the pipeline meets the requirements for coverage under the Gas Code. The Australian Competition and Consumer Commission's assessment of the part IIIA undertaking should be held over, pending the outcome of the triggered coverage assessment and decision.

Access arrangements

FINDING 7.1

Redistributing efficiency gains to users on an ex post basis could decrease the scope for regulatory error. However, this might come at the expense of reducing the incentive properties of the current ex ante approach.

FINDING 7.2

Replicating the outcome of a competitive market (s.8.1(b) of the Gas Code) is an unachievable objective for setting reference tariffs. Seeking to apply the concept of workable competition does not provide a practical approach to this problem.

FINDING 7.3

There would be benefits in replacing the existing reference tariff objectives (s.8.1 of the Gas Code) with the pricing principles that the Australian Government has agreed to adopt for the national access regime. This would provide more specific and operational guidance for setting reference tariffs under the Gas Access Regime and ensure consistency with the national access regime.

In order to provide more specific and operational guidance for setting reference tariffs under the Gas Access Regime, and ensure consistency with the national access regime, s.8.1 of the Gas Code should be replaced with the following:

s.8.1 A reference tariff or reference tariff policy should be designed with regard to the overarching objects clause, s.2.24 and the following principles:

- (a) that reference tariffs should:*
 - (i) be set so as to generate expected revenue for a reference service or services that is at least sufficient to meet the efficient costs of providing access to the reference service or services*
 - (ii) include a return on investment commensurate with the regulatory and commercial risks involved*
- (b) that reference tariff structures should:*
 - (i) allow multi-part pricing and price discrimination when it aids efficiency*
 - (ii) not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to non-associates is higher*
- (c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.*

To ensure there is no conflict with the pricing principles specified in recommendation 7.1, the following should be deleted from the Gas Code:

- the overview in italics at the beginning of s.8*
- ss8.2(c), 8.3(a), 8.38–8.43 and 8.45.*

RECOMMENDATION 7.3

To ensure there is no conflict with the pricing principles specified in recommendation 7.1, the first paragraph of s.8.44 of the Gas Code should be changed to:

s.8.44 The Reference Tariff Policy should, wherever the Relevant Regulator considers appropriate, contain a mechanism (an Incentive Mechanism) that permits the Service Provider to retain all, or any share of, any returns to the Service Provider from the sale of Reference Services in aggregate (not individual Reference Services when there is more than one):

And s.8.46 of the Gas Code should be changed to:

s.8.46 The design of an Incentive Mechanism should be consistent with achieving the overall objective of the Gas Access Regime and the pricing principles specified in s.8.1.

RECOMMENDATION 7.4

To ensure the guidance given to regulators is consistent with recommendation 7.1, s.8.6 of the Gas Code should be changed to the following:

s.8.6 In view of the manner in which the Rate of Return, Capital Base, Depreciation Schedule and Non Capital Costs may be determined (in each case involving various discretions), a range of values may be attributed to the Total Revenue described in section 8.4. In order to assess whether a value proposed by a Service Provider is within this range the Relevant Regulator may have regard to any financial and operational performance indicators it considers relevant in order to determine whether the level of costs nominated by the Service Provider is within the range of plausible outcomes under section 8.4 that is consistent with the pricing principles contained in section 8.1.

RECOMMENDATION 7.5

To provide greater flexibility for price regulation than that provided by the current building block approach, s.8.5 of the Gas Code should be replaced with the following:

s.8.5 A Service Provider can use another method to calculate Total Revenue, provided the Relevant Regulator is satisfied that the proposed method is more likely to meet the overall objective of the Gas Access Regime.

FINDING 7.4

The Commission supports continuing efforts to find improved ways of determining the path of reference tariffs from one access arrangement review to the next.

RECOMMENDATION 7.6

Section 8.21 of the Gas Code should be amended so that regulators can, at their discretion, undertake less public consultation than is required for a proposed revision to an access arrangement under s.2.28. If this discretion is exercised, the regulator should issue a written statement outlining clearly why the reduced public consultation was justified prior to issuing a binding decision under s.8.21 that proposed investment in an extension or expansion of a covered pipeline would meet the requirements for incorporation into the capital base.

RECOMMENDATION 7.7

To ensure there is no conflict with the pricing principles specified in recommendation 7.1, s.8.26(c) of the Gas Code should be deleted.

RECOMMENDATION 7.8

To ensure there is no conflict between the depreciation provisions of the Gas Code and the pricing principles specified in recommendation 7.1, ss8.32, 8.33(a) and 8.34(d) should be replaced with the following:

s.8.32 The Depreciation Schedule is the set of depreciation schedules (one of which may correspond to each asset or group of assets that form part of the Covered Pipeline) that is the basis upon which the assets that form part of the Capital Base are to be depreciated for the purposes of satisfying the pricing principles in section 8.1.

s.8.33(a) so as to result in the expected Total Revenue attributable to a Service Provider's Reference Services in aggregate (not individual Reference Services when there is more than one) changing over time in a manner that is consistent with the efficient operation and use of the Services (and which may involve a substantial portion of the depreciation taking place in future periods, particularly where the calculation of Total Revenue has assumed significant market growth and the Pipeline has been sized accordingly);

s.8.34(d) the expected Total Revenue attributable to a Service Provider's Reference Services in aggregate (not individual Reference Services when there is more than one) should change over the Access

Arrangement Period in a manner that is consistent with the efficient operation and use of the Services (and which may involve a substantial portion of the depreciation taking place towards the end of the Access Arrangement Period, particularly where the calculation of Total Revenue has assumed significant market growth and the Pipeline has been sized accordingly).

RECOMMENDATION 7.9

To ensure regulators are given clear guidance about the uncertainty associated with calculating an ex ante regulatory rate of return, s.8.31 of the Gas Code should be changed to the following:

s.8.31 If a Rate of Return is used in determining a Reference Tariff then the method used to calculate the Rate of Return and the values used in applying that method shall in the first instance be proposed by the Service Provider. In assessing the Service Provider's proposal the Relevant Regulator must take account of the fact that there is no single correct method to determine a Rate of Return and there is often a range of plausible estimates that could be used in applying a Rate of Return method. The role of the Relevant Regulator is therefore to assess whether the Service Provider's:

- (a) proposed method has a plausible conceptual basis; and*
- (b) values used in applying the method lie within the range of plausible estimates.*

The Relevant Regulator must approve the proposed method if (a) is satisfied. The Relevant Regulator must approve the values used in applying a method if (b) is satisfied.

RECOMMENDATION 7.10

To ensure that the Gas Code is consistent with recommendations 7.1 and 7.5, s.8.30 of the Gas Code should be changed to the following:

s.8.30 If a Rate of Return is used in determining a Reference Tariff then the Rate of Return should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service (as reflected in the terms and conditions on which the Reference Service is offered and any other risk associated with delivering the Reference Service including that resulting from regulation).

FINDING 7.5

There is disagreement among technical experts about how regulatory rates of return (WACC) in Australia compare to those in other countries. This illustrates the inevitable imprecision and subjectivity that occurs when regulators are required to approve reference tariffs.

RECOMMENDATION 7.11

A study should be undertaken by a group of recognised experts in the field of financial economics that considers whether a robust method can be developed for setting businesses' expected rate of return on capital under incentive regulation. This should include a review of the use of the capital asset pricing model by Australian regulators.

FINDING 7.6

Simplifying the Gas Code's competitive tendering provisions would make them more flexible and less costly. For example, the tender approval process could be streamlined by allowing a person simultaneously tendering for both a transmission and distribution system to have the tender process considered by a single regulator.

RECOMMENDATION 7.12

To enable regulators to assess the cost allocations used to determine a service provider's total revenue, a new clause should be inserted in s.7 of the Gas Code as follows:

- During the Access Arrangement Period the Service Provider should collect and maintain data on the variables used as the basis of cost allocations for the purpose of deriving Total Revenue.***

RECOMMENDATION 7.13

The Gas Code should be amended so that the information that service providers are required to provide under ss2.6–2.7 and attachment A does not include information on cost allocations between different reference services (where there is more than one) or between users.

FINDING 7.7

Regulators are currently seeking to have their powers under the Gas Access Regime extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.

FINDING 7.8

There is scope for some regulators to use State-based powers to obtain information from regulated distributors that is beyond what is specified in the Gas Access Regime. This could impose unwarranted costs and lead to inconsistencies in the information requirements on service providers across jurisdictions.

RECOMMENDATION 7.14

To ensure that regulators cannot use State-based powers to access information beyond that specified in the Gas Access Regime, a new clause should be inserted into s.7 of the Gas Code as follows:

- ***The Relevant Regulator for the purposes of approving a Service Provider's Access Arrangement can only use information collected under the information collection powers specified in the Gas Access Regime.***

RECOMMENDATION 7.15

Section 3.16 of the Gas Code should be amended so that it unambiguously clarifies that any expansion of a covered pipeline will also be covered.

FINDING 7.9

There is high potential for regulatory error when approving reference tariffs. The Gas Access Regime requires regulators to make decisions about future market circumstances that are uncertain. This has led regulators to use many debatable assumptions. There is a consequential tendency for regulators to seek additional information from service providers and further studies by consultants. This is unlikely to reduce uncertainty significantly.

FINDING 7.10

The current regulatory approach of cost-based price regulation is costly, especially in relation to the market impact. Therefore, while some refinements to the existing regulatory approach are needed, there is a sound basis also for an alternative less costly approach in certain circumstances that will generate larger net benefits.

Light-handed regulation

RECOMMENDATION 8.1

The Gas Access Regime should be amended to provide for a light-handed form of regulation as an alternative to regulation involving an access arrangement with reference tariffs. The light-handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.

RECOMMENDATION 8.2

The proposed monitoring form of regulation to be incorporated into the Gas Access Regime should have the following features:

- *a third party access policy formulated by the service provider which would have some minimum requirements relating to processes for negotiating access and binding arbitration in the event of a dispute over access*
- *subjecting service providers to provisions for anticompetitive conduct (the current s.13 of schedule 1 of the Gas Pipelines Access Law)*
- *minimum ring fencing provisions*
- *public disclosure of specified information by the service provider for monitoring purposes only (which would be well short of the ‘access arrangement information’ currently required under the Gas Code)*
- *scope for the service provider to adopt, at its discretion, additional features, such as a voluntary code of conduct.*

RECOMMENDATION 8.3

The access policy prescribed by service providers under the proposed monitoring regime should include at a minimum:

- *processes for negotiating access*
- *dispute resolution procedures (including provision for binding commercial arbitration).*

FINDING 8.1

A service provider in formulating its access policy would be guided by the requirements of parts of s.3 of the Gas Code, which includes:

- *a services policy (ss3.1–3.2)*
- *a reference tariff and a reference tariff policy (ss3.3 and 3.5)*
- *the terms and conditions of supply (s.3.6)*

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- *a capacity management policy (s.3.7)*
 - *a trading policy (ss3.9–3.11)*
 - *a queuing policy (ss3.12–3.13 and 3.15)*
 - *an extensions/expansions policy (s.3.16).*

RECOMMENDATION 8.4

Under the proposed monitoring regime, to encourage service providers to provide third party access, service providers and related parties should be subject to the anticompetitive conduct provisions of the Gas Pipelines Access Law dealing with preventing or hindering access (s.13 of schedule 1 of the Gas Pipelines Access Law).

RECOMMENDATION 8.5

Under the proposed monitoring regime, a service provider should comply with the minimum ring fencing requirements in s.4.1 of the Gas Code. However, s.4.1(e) should not apply for monitored pipelines, rather a new alternative provision should apply as follows:

allocate any costs that are shared between an activity that is covered by a set of accounts described in s.4.1(c) and any other activity according to a methodology for allocating costs that is transparent and disclosed as part of the monitoring regime information disclosure requirements.

RECOMMENDATION 8.6

Under the proposed monitoring regime, information disclosure requirements should involve:

- *focusing more on trend performance, including profitability*
- *reporting and monitoring after the event, without any need for prior endorsement by the regulator*
- *the regulator particularly recording cases where access negotiations have been unsuccessful.*

RECOMMENDATION 8.7

To improve regulatory certainty, and reduce the possibility of regulatory creep, information disclosure requirements of the proposed monitoring regime should be set out in disclosure guidelines developed prior to implementation of the monitoring regime. The National Competition Council, or another suitable organisation other than the regulator undertaking the monitoring function, should be responsible for developing this generic set of guidelines. This should

involve an open and transparent consultative process. It should be the responsibility of the entity developing the guidelines (the National Competition Council, for example) to update the guidelines when substantive need arises.

FINDING 8.2

The following information could guide the body responsible for developing the information disclosure requirements:

- Access provision information including number of negotiations commenced in the year, number of negotiations completed resulting in an access agreement being negotiated, number of access negotiations withdrawn from by the access seeker, number of access negotiations withdrawn from by the service provider, number of negotiations in dispute, number of dispute resolution processes commenced and still in progress, and number of dispute resolution processes completed (with an accompanying note about the outcomes of completed dispute resolution processes).*
- High level financial information (for example, a statement of financial position, a statement of financial performance, and a statement of cash flow) that accords with the ring fencing requirements in s.4 of the Gas Code. There should be disclosure of notes to the financial statements and any other information necessary to give a true and fair view.*
- Operational statistics including quantities and prices for aggregated inputs, quantities and prices for monitored services and the percentage change.*
- Information on dealings with associates including details of the associates, aggregated total revenue from associates, aggregated total volume sold to associates and an aggregate index of the price deviation for transactions with associates (including disclosure of the index method).*

The Commission envisages monitoring information would be published annually for each pipeline. The information to be reported would not be overly onerous and preferably would comprise information that is already collected by service providers. The information disclosure guidelines would not specify disclosure of the weighted average cost of capital (WACC).

RECOMMENDATION 8.8

The relevant regulator should collate and publish annually the information disclosed by a service provider under the proposed monitoring regime. Any commentary made by the regulator should be of a factual nature only, for example, the regulator should not make any determinations on the appropriateness of costs and prices.

RECOMMENDATION 8.9

To ensure the data disclosed by service providers under the proposed monitoring regime are accurate:

- *chief executive officers (CEOs) should be required to sign a declaration stating that the data are true*
- *financial information and financial performance measures should be certified by an auditor*
- *financial penalties should be available through the courts if companies refuse to provide the required monitoring data within the established deadlines.*

RECOMMENDATION 8.10

Where the proposed monitoring option is applied, it should apply for a minimum period of five years, during which there would be no shift to access arrangement with reference tariffs regulation. Following this period, monitoring would continue to apply, subject to a decision by the Minister, following a recommendation by the National Competition Council, and an application from the monitoring regulator that access arrangement with reference tariffs regulation should apply. A decision to continue with monitoring would apply for a five-year period. Any person can apply for revocation of coverage of a monitored pipeline at any time.

RECOMMENDATION 8.11

For pipelines that are covered and subject to the proposed monitoring regime, only the relevant regulator should be able to apply to the National Competition Council to shift the form of regulation to access arrangements with reference tariffs.

FINDING 8.3

The effectiveness of monitoring regulation depends in part on the threat of access arrangement with reference tariffs regulation possibly being applied in the future. The service provider's commercial behaviour will be influenced by the threat of being subject to access arrangement with reference tariffs regulation at the end of five years.

Pipelines currently covered with cost-based price regulation should remain covered, and continue to be subject to the access arrangement with reference tariffs regulation. Movement from this price regulation would require an application to the National Competition Council for revocation. Following a recommendation from the National Competition Council, the Minister would make a decision on coverage, and the form of regulation where coverage is retained.

To give primacy to the Gas Access Regime and to reduce forum shopping, it is necessary to have the Gas Access Regime certified as effective under part IIIA of the national access regime. It is likely that the relevant Minister, following a recommendation from the National Competition Council, would be able to certify the new regime effective.

To remove uncertainty, pending a decision by the Minister following a recommendation from the National Competition Council that the Gas Access Regime would be certified as effective, clause 6 of the Competition Principles Agreement should be modified as supported by the Australian Government in its response to the recommendation in the Commission's review of the national access regime.

Investment and access arrangements

The Australian Competition and Consumer Commission's draft greenfields guideline does not substantially alter the potential for the Gas Access Regime to discourage investment. This is because the published guideline:

- *is only a draft (and has been so for at least two years)*
- *maintains the wide discretion that the Gas Code gives to regulators to set key regulatory parameters.*

FINDING 9.2

Extended access arrangement periods might reduce the risk of unforeseen changes in regulatory parameters (parameter risk). However, the extent to which risk is reduced depends on the types of review mechanisms that regulators require in an access arrangement of extended duration.

FINDING 9.3

Fixed principle provisions that allow some regulatory parameters to be locked in for a certain period have the potential to reduce the risk of future changes in a regulator's behaviour (parameter risk). However, the extent to which risk is reduced is limited. The extent of risk reduction depends on the fixed period allowed by regulators and on which parameters can be fixed.

RECOMMENDATION 9.1

The Gas Access Regime should be amended so that the relevant Minister, after receiving a recommendation from the National Competition Council, can provide a binding no-coverage ruling for a proposed pipeline if it does not meet the coverage criteria. A binding no-coverage ruling should remain in effect for 15 years from when the pipeline commences operations, unless the information relied on by the relevant Minister or National Competition Council was intentionally misleading. After 15 years of operation, a pipeline that was subject to a binding no-coverage ruling should continue to remain uncovered unless there is a successful coverage application.

RECOMMENDATION 9.2

If recommendation 9.1 is implemented, then the national access regime (part IIIA of the Trade Practices Act 1974) should be amended so that a gas pipeline cannot be declared while it is subject to a binding no-coverage ruling under the Gas Access Regime.

FINDING 9.4

Approval of an access arrangement (including reference tariffs) before construction could reduce the risk of future changes in a regulator's behaviour (parameter risk). However, pipeline investors would be unlikely to seek to be subject to a regulator approved access arrangement with reference tariffs, given the costs and time involved and the information disclosure requirements.

FINDING 9.5

Adding a fixed premium could address the asymmetric truncation of returns to some extent. A fixed premium would be a low-cost mechanism to promote investment, given its low administrative costs and the limited scope for strategic behaviour. However, it involves difficult implementation issues, such as the level of the premium and whether it should be restricted to riskier greenfield projects.

FINDING 9.6

A benefit/loss (symmetric) sharing mechanism is not a satisfactory means of mitigating the investment distorting effects of price regulation from truncating upside returns. Such a mechanism shifts both downside and upside risk from investors to users. Even if such a risk transfer was considered appropriate, benefit/loss sharing mechanisms would be subject to a wide range of practical problems.

FINDING 9.7

It is appropriate for service providers to have the right to seek revisions to their access arrangement at any time if demand is lower than forecast. This limits the damage caused by regulatory error. However, service provider initiated reviews are not an effective mechanism for addressing the investment distorting effects of asymmetric truncation.

FINDING 9.8

The Commission's recommendation to introduce binding no-coverage rulings would give regulation free periods of at least 15 years to new pipelines that do not satisfy the coverage criteria. Extending the application of regulation free periods to new pipelines that satisfy the coverage criteria could reduce competition in upstream and downstream markets, and possibly distort investment. The case for providing regulation free periods to all new pipelines is weakened further by the Commission's recommendation to have a monitoring option as an alternative to a regulated access arrangement with reference tariffs.

Ring fencing and associate contracts

FINDING 10.1

The ring fencing and associate contract provisions of the Gas Code are warranted and are important for an effective regulatory regime.

FINDING 10.2

The requirement under s.7.1 of the Gas Code that a service provider seek authorisation for the supply of a reference service at the reference tariff imposes costs on the service provider, with little apparent benefit.

RECOMMENDATION 10.1

Section 7.1 of the Gas Code should be amended so that a service provider entering an associate contract for the supply of a reference service at the reference tariff is not required to seek authorisation. However, the service provider must provide the contract and any necessary information to the relevant regulator to satisfy the regulator that it is a contract for a reference service at the reference tariff.

FINDING 10.3

Approval of asset management contracts under the associate contract provisions is unnecessary.

RECOMMENDATION 10.2

The associate contract provisions should be amended to clarify that these provisions do not apply to asset management contracts.

RECOMMENDATION 10.3

To ensure regulators can adequately assess the costs of an associated business that undertakes activities under service agreements and contractual arrangements with a service provider in relation to a covered pipeline, the following subsections should be added to s.4.1 of the Gas Code:

s.4.1B An Associate of a Service Provider of a Covered Pipeline that undertakes activities under service agreements and contractual arrangements with a Service Provider in relation to the Covered Pipeline must (if requested by the Relevant Regulator):

- (a) establish and maintain a separate set of accounts in respect of the Services provided to the Covered Pipeline***
- (b) allocate any costs that are shared between an activity that is covered by a set of accounts described in s.4.1B(a) and any other activity according to a methodology for allocating costs that is transparent.***

s.4.1CA Service Provider when entering service agreements and contractual arrangements with an Associate for activities undertaken in relation to a covered pipeline, must ensure that the terms and conditions of the contract will allow s.4.1B to be implemented.

RECOMMENDATION 10.4

To ensure regulators can adequately assess the costs of an associated business that undertakes activities under service agreements and contractual arrangements with a service provider in relation to the covered pipeline, the following subsection should be added to s.4.2 of the Gas Code:

s.4.2A In complying with ss4.1B(a) and (b) an Associate of a Service Provider must:

- (a) if the Relevant Regulator has published general accounting guidelines for Associates which apply to the accounts being prepared, comply with those guidelines; or***
- (b) if the Relevant Regulator has not published such guidelines, comply with guidelines prepared by the Associate and approved by the Relevant Regulator or, if there are no such guidelines, comply with such guidelines (if any) as the Relevant Regulator advises the Associate apply to that Associate from time to time.***

Such guidelines may, amongst other things, require the accounts to contain sufficient information, and to be presented in such a manner, as would enable the assessment (and benchmarking) by the Relevant Regulator of the costs of the activities undertaken in relation to the Covered Pipeline by an Associate under service agreements and contractual arrangements with a Service Provider.

RECOMMENDATION 10.5

To remove potentially conflicting objectives from the Gas Access Regime, s.4.1(e) of the Gas Code should be amended to delete reference to the term ‘otherwise fair and reasonable’.

FINDING 10.4

The Gas Access Regime already provides adequate safeguards to ensure that asset operators and managers that undertake activities in upstream and downstream markets do not use their operation and management roles to behave anticompetitively.

Administrative and appeal processes

FINDING 11.1

There are valid concerns about the inadequate timeliness of regulatory decisions in some cases under the Gas Access Regime.

RECOMMENDATION 11.1

The Gas Access Regime should be amended, whereby the regulator would be able to extend the period for approval of an access arrangement by two months only once. If judicial proceedings commence, the regulator's time should automatically be extended by the length of time taken to complete the judicial proceedings.

RECOMMENDATION 11.2

The Gas Access Regime should be amended whereby the 'further final decision' should be removed from the approval process for access arrangements.

RECOMMENDATION 11.3

The Gas Access Regime should be amended so regulators can specify a date by which the service provider must submit proposed amendments to an access arrangement.

RECOMMENDATION 11.4

Limitations on the grounds of appeal under s.39 of the Gas Pipelines Access Law should be removed to allow a full merits review on access arrangements drafted and approved by the regulator. This would be consistent with the grounds of merits review for coverage decisions.

RECOMMENDATION 11.5

The material that can be introduced to the appeal body for a merits review of a coverage decision under s.38 of the Gas Pipelines Access Law should be restricted to material that has already gone before the primary decision maker. This would be consistent with the merits review process for access arrangements drafted and approved by the regulator.

FINDING 11.2

The application of the Australian Government's cost recovery policy to the funding of a national regulator through an industry levy would bring rigour to the funding arrangements proposed by the Ministerial Council on Energy.

Institutional arrangements

FINDING 12.1

The Council of Australian Governments and the Ministerial Council on Energy are progressing the reform program for the energy sector. The governance arrangements involving the division of responsibilities and functions among the MCE, the Australian Energy Market Commission, and the Australian Energy Regulator apply the principle of the separation of policy development from the administration of policy.

FINDING 12.2

While there are some issues common to the electricity and gas supply sectors, there are significant differences, including in relation to market structure, size and maturity, market rules, nature of energy generation and transportation technology. These differences have implications for investment, risks and appropriate regulation.

FINDING 12.3

Similar considerations are relevant for making decisions about coverage and the form of regulation. (These considerations also apply to both transmission and distribution infrastructure for natural gas.) The same agency should make recommendations on these issues.

FINDING 12.4

There are sound reasons for the agency responsible for developing the information disclosure guidelines, and updating them when the need arises, being separate from the agency administering the monitoring function.

RECOMMENDATION 12.1

The agency that recommends coverage of a pipeline, should also be responsible for recommending the form of regulation to apply to the pipeline.

RECOMMENDATION 12.2

The agency responsible for making recommendations on pipeline coverage and form of regulation decisions (currently the National Competition Council) should be separate from the regulator actually responsible for administering the regulation (either monitoring or access arrangements with a reference tariff).

FINDING 12.5

The National Gas Pipelines Advisory Committee is not working effectively, and significant reform is necessary. The Ministerial Council on Energy's proposal for the Australian Energy Market Commission to be responsible for managing the code change processes would seem to address the concerns about NGPAC.

FINDING 12.6

Ultimate responsibility for decisions on pipeline coverage, the form of regulation and major changes to the Gas Code should continue to reside at the ministerial level. The Ministerial Council on Energy's proposed framework for code change accommodates this approach. It appears that the MCE would delegate most determinations on code changes to the Australian Energy Market Commission (which is accountable to the MCE). However, some changes, including changes to MCE policy protected provisions of the Gas Code, require decision by the MCE.

FINDING 12.7

The reforms of the Gas Access Regime recommended by the Commission in this report would fit within the institutional arrangements developed by the Ministerial Council on Energy for a national approach to energy access regulation involving the Australian Energy Market Commission and the Australian Energy Regulator.